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No. 92-479

IN THE
Supreme Court of the United States
OCTOBER TERM, 1992

TXO PRODUCTION CORP.,
Petitioner

v.

ALLIANCE RESOURCES CORP.,
TUG FORK LAND COMPANY,
GEORGE KING, and GROVER C. GOODE,
Respondents

On Writ of Certiorari to the Supreme Court of Appeals of West Virginia

BRIEF OF ARTHUR ANDERSEN & CO., COOPERS & LYBRAND, DELOITTE & TOUCHE, ERNST & YOUNG, KPMG PEAT MARWICK, AND PRICE WATERHOUSE AS AMICI CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Amici will address the following question, which is encompassed in Question 2 in the petition for writ of certiorari:

Whether the standard for determining when an award of punitive damages is excessive, in violation of the Due Process Clause of the Fourteenth Amendment, should turn only upon the numerical relationship between the amount of the punishment and the amount of compensatory damages.

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INTEREST OF THE AMICI CURIAE

With the written consent of the parties pursuant to Rule 37 of the Rules of this Court, the amici curiae submit this brief in support of petitioner.

The amici curiae are firms engaged in the practice of the profession of accounting and auditing. They are the six largest firms practicing this profession in the United States and, collectively, report on the fi-

nancial statements of more than 90 percent of those companies whose securities are publicly traded in the United States.

Congress long ago concluded that independent public accountants perform an important public service. The Securities Act of 1933 and the Securities Exchange Act of 1934 require all public companies whose securities are registered with the Securities and Exchange Commission to have their financial statements examined by public accountants. *See* 15 U.S.C. § 77aa (Schedule A) (25)-(27) (registration statements required by the Securities Act for public offerings must contain financial statements that have been examined by a public accountant); *id.* § 78*l*(b)(1)(J)-(K) (same for registration under the Exchange Act of any security to be traded on an exchange).

Chronically targeted by plaintiffs as the "deep pocket" in various types of commercial tort litigation, amici have witnessed a sharp increase in the number of state and federal law claims filed against them. Based ostensibly on their rendition of professional services, amici have become "institutional defendants": the number of such claims filed against amici has quadrupled in the last decade. The size of the damage awards also has increased exponentially, culminating in a $338 million jury verdict against an accounting firm in 1992. Collectively, amici paid $404 million nationwide in litigation-related costs in 1990 and $477 million in 1991—nine percent of their United States auditing and accounting revenues.[1]

[1] There is nothing to suggest that this increase in actions and damages is related in any way to a decline in the quality of professional services rendered by independent auditors. *Cf.* Daniel R. Fischel, *The Regulation of Accounting: Some*

And amici are concerned that their increasing exposure to the risks of litigation will impede their recruitment and retention of the most qualified of professional personnel. *See* Alison Leigh Cowan, *The New Letdown: Making Partner*, N.Y. Times, Apr. 1, 1992, at D1 (benefits of partnership do not offset the greater exposure to lawsuits and firm's financial problems); Michael S. Raab, *Detecting and Preventing Financial Statement Fraud: The Roles of the Reporting Company and the Independent Auditor*, 5 Yale L. & Pol'y Rev. 514, 526 (1987) (footnote omitted) (accounting profession is "finding it increasingly difficult to attract quality personnel").

Even in those instances where the plaintiff's underlying claim is meritless, the lawsuits filed against amici often contain a demand for punitive damages. A classic in terrorem litigation tactic, such a demand operates to imbue a lawsuit with "a settlement value to the plaintiff out of any proportion to its prospect of success at trial." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975). Legal strategies are sometimes skewed as a result, with a consequent increase in litigation costs. Because of the substantial impact of even the threat of punitive damages on a profession whose activities Congress has found to be in the public interest, amici believe that

Economic Issues, 52 Brook. L. Rev. 1051, 1054 (1987) ("Unless there is some amazing coincidence whereby a high percentage of wrongdoers wind up in particular industries, . . . it is implausible that the problems of an entire industry are attributable to disclosure decisions by firms and their accountants."). Instead, amici suggest that they, like much of corporate America, have simply been caught up in the "tort explosion" of recent years. *See generally* Peter W. Huber, *Liability: The Legal Revolution and Its Consequences* (1988).

their views on the question of constitutional limits on the imposition of punitive damages may assist the Court in its consideration of this case.

SUMMARY OF ARGUMENT

The amount of punitive damages that may be exacted from a defendant in a particular case is a matter of local law in the first instance, but—as is the case with any governmental action that effects a deprivation of property—punitive damages awards also must comply with the requirements of the Due Process Clause. This Court indicated as much in its decision in *Pacific Mutual Life Insurance Co. v. Haslip*, 111 S. Ct. 1032 (1991), examining not only the procedures by which the punishment was determined, but also the reasonableness of the amount of the award. And, *Pacific Mutual* itself is simply the latest in a long line of this Court's decisions establishing that a civil penalty violates due process if it is disproportionate to the objectives sought to be achieved by the imposition of such punishment.

There accordingly can be no doubt about the applicability of the substantive component of the Due Process Clause to the issue presented here. A punitive damages award that is not rationally related to the purposes of punitive damages is unconstitutionally excessive.

Much of the argument in the certiorari petition, and the discussion in the lower court's opinion, focuses on the ratio between the punitive award and the compensatory damages. While that ratio is one factor that may be considered in assessing the constitutionality of a punitive award—and a ratio such as that in this case almost certainly indicates the award's unconstitutionality—the converse assuredly

is not true. *A punitive award that is only a small multiple of the compensatory damages may also be irrational.* Multiplication of compensatory damages leads to excessive results when, as with amici, potentially very large compensatory awards—themselves wholly disproportionate to both the relatively small gains realized by the alleged wrongdoer and the nature of the alleged wrongdoing—already provide substantial punishment and deterrence. Thus, although a state court may choose to look to a multiple as a general guidepost, it cannot end its inquiry with that multiple. Instead, a court determining whether an award comports with due process must examine a variety of factors in order to decide whether the award is constitutionally permissible. A simple comparison of the amounts of punitive and compensatory damages will not suffice to establish the constitutionality of a punitive damages award.

ARGUMENT

THE DUE PROCESS STANDARD FOR ASSESSING THE REASONABLENESS OF AN AWARD OF PUNITIVE DAMAGES SHOULD NOT TURN SOLELY ON THE RATIO BETWEEN PUNITIVE AND COMPENSATORY DAMAGES

A. The Due Process Clause Of The Fourteenth Amendment Prohibits The Imposition Of Punitive Exactions That Are Arbitrary And Irrational

The Due Process Clause of the Fourteenth Amendment, "like its forebear in the Magna Carta, was 'intended to secure the individual from the arbitrary exercise of the powers of government.'" *Daniels v. Williams*, 474 U.S. 327, 331 (1986) (quoting *Hurtado v. California*, 110 U.S. 516, 527 (1884)) (citation omitted) (original source omitted). The Due

Process Clause requires that the government follow appropriate procedures in taking certain actions—procedural due process—and bars other actions entirely, "regardless of the fairness of the procedures used to implement them"—substantive due process. *Id.* Due process is not a technical concept and cannot be applied mechanically. Instead, due process "expresses the requirement of 'fundamental fairness,'" *Lassiter v. Department of Social Services*, 452 U.S. 18, 24 (1981), and "prevents the government from engaging in conduct that 'shocks the conscience.'" *United States v. Salerno*, 481 U.S. 739, 746 (1987) (quoting *Rochin v. California*, 342 U.S. 165, 172 (1952), *overruled on other grounds by Mapp v. Ohio*, 367 U.S. 643 (1961)).

The Court has already held that punitive damages awards are subject to the strictures of the Due Process Clause. In *Pacific Mutual*, the Court analyzed Alabama's procedural safeguards for an award of punitive damages and determined that Alabama's scheme passed constitutional muster from a procedural perspective. 111 S. Ct. at 1043-1046.

The Court also considered the petitioner's substantive due process challenge to the size of the punitive damages award, finding that the award of more than four times compensatory damages "may be close . . . [but] does not cross the line into the area of constitutional impropriety." 111 S. Ct. at 1046 (footnote omitted). Although acknowledging that it could not "draw a mathematical bright line between the constitutionally acceptable and the constitutionally unacceptable that would fit every case," the Court observed that unlimited discretion "in the fixing of punitive damages may invite extreme results that jar one's constitutional sensibilities." *Id.* at 1043. *See*

also Browning-Ferris Indus., Inc. v. Kelco Disposal, Inc., 492 U.S. 257, 276 (1989) ("There is some authority in our opinions for the view that the Due Process Clause places outer limits on the size of a civil damages award made pursuant to a statutory scheme") (citing *St. Louis, I. Mt. & So. Ry. v. Williams*, 251 U.S. 63 (1919)); *Germanio v. Goodyear Tire & Rubber Co.*, 732 F. Supp. 1297, 1300 (D.N.J. 1990) ("[W]e think that [*Browning-Ferris* and *Pacific Mutual*] can only be taken as evidence that an unreasonably generous award of punitive damages may be attacked under the Due Process Clause, which is hardly news.").[2]

Indeed, the Court has long held that the Due Process Clause prohibits excessive civil monetary penalties in litigation between private parties, just as it does

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[2] The conclusion that awards of punitive damages must comport with due process requirements is entirely unsurprising: punitive awards plainly constitute a government-compelled deprivation of property. A punitive damages award is embodied in the judgment of a state court—which itself constitutes state action—and state law obligates the defendant to pay the judgment. *See Lugar v. Edmondson Oil Co.*, 457 U.S. 922 (1982) (state action present when creditor, pursuant to state law, attached debtor's property in an ex parte proceeding); *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 429 (1982) (protections of the Due Process Clause extend to "civil . . . defendants [seeking] to protect their property"); *New York Times Co. v. Sullivan*, 376 U.S. 254, 265 (1964) (citation omitted) ("Although this is a civil lawsuit between private parties, the Alabama courts have applied a state rule of law . . . . It matters not that that law has been applied in a civil action and that it is common law only, though supplemented by statute. The test is not the form in which state power has been applied but, whatever the form, whether such power has in fact been exercised.").

in actions brought by the state. *St. Louis, I. Mt. & So. Ry.*, 251 U.S. at 66-67 (action by passenger against railroad) (Due Process Clause "places a limitation upon the power of the States to prescribe [civil] penalties" that are disproportionate and unreasonable).[3] And the Court has invalidated civil penalties on due process grounds. For example, in *Missouri Pacific Ry. v. Tucker*, 230 U.S. 340 (1913), an action by a consignee against a railroad, the Court struck down a penalty of $500 for a $3.02 overcharge, holding that the penalty was "grossly out of proportion to the possible actual damages" and therefore in violation of due process. 230 U.S. at 351 (citing *Waters-Pierce Oil Co. v. Texas*, 212 U.S. 86, 111 (1909)); *see also Southwestern Tel. & Tel. Co. v. Danaher*, 238 U.S. 482, 490-491 (1915) (invalidating penalty on due process grounds in an action against telephone company by customer). *Pacific Mutual* properly determined that these principles apply with the same force to awards of punitive damages.

Although substantive due process does not, as a term standing alone, lend itself to a single complete *and* precise definition, the Court has made clear that government action that bears no rational relationship to legitimate governmental purposes is arbitrary, irrational, and violates due process. *See Hodel v. Indiana*, 452 U.S. 314, 331 (1981); *Moore v. City of East Cleveland, Ohio*, 431 U.S. 494, 498 & n.6

[3] Of course, the Court has also recognized that excessive fines remitted to the state violate due process. *See Waters-Pierce Oil Co. v. Texas*, 212 U.S. 86, 111 (1909) (Constitution would be violated by "fines . . . [that] are so grossly excessive as to amount to a deprivation of property without due process of law").

(1977); *see also Committee of U.S. Citizens in Nicaragua v. Reagan*, 859 F.2d 929, 943-944 (D.C. Cir. 1988). Any government-compelled deprivation of property therefore must be rationally related to legitimate governmental objectives to pass muster under the Due Process Clause.

Pacific Mutual illustrates the difficulty in determining whether a specific award of punitive damages comports with the requirements of due process. The Court's expression of the problem, however, provides no basis for abstaining from giving content to this constitutional right or for adopting a wholly subjective and standardless inquiry. Instead, the proper approach is to assess the constitutionality of a punitive damages award by evaluating whether it is no more than what is reasonably necessary to accomplish the underlying governmental purposes. That is what the Court does in other contexts in which it must evaluate the proportionality and reasonableness of government action. *See Salerno*, 481 U.S. at 754 (emphasis added) ("when the Government has admitted that its only interest is in preventing flight, bail must be set by a court at a sum designed to ensure that goal, *and no more*"); *Enmund v. Florida*, 458 U.S. 782, 800-801 (1982) (criminal sentence justified by reference to purposes of criminal penalties—punishment and deterrence); *United States v. United Mine Workers*, 330 U.S. 258, 304 (1947) (a court should calculate the appropriate fine for civil contempt by looking to the purposes for which the fine is imposed); *Chicago & N.W. Ry. v. Nye Schneider Fowler Co.*, 260 U.S. 35, 44 (1922) (civil penalties must be "reasonably sufficient to accomplish their legitimate object").

The deprivation of property through punitive damages has as its purposes punishment and deterrence. *Smith v. Wade*, 461 U.S. 30, 54 (1983) (quoting Restatement (Second) of Torts § 908(1) (1979)) (alteration in original) ("Punitive damages are awarded in the jury's discretion 'to punish [the defendant] for his outrageous conduct and to deter him and others like him from similar conduct in the future.' "); *International Bhd. of Elec. Workers v. Foust*, 442 U.S. 42, 48 (1979) (citation and internal quotation marks omitted) ("Punitive damages are not compensation for injury. Instead, they are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence."); Restatement (Second) of Torts § 908 cmt. a (1979).

So long as an award of punitive damages is "no more" than is "reasonably calculated" to serve the purposes of deterrence and punishment, it should pass muster under the Due Process Clause. However, to the extent an award of punitive damages exceeds the amount necessary to punish and deter, it is arbitrary, irrational, and violates substantive due process. *See Chicago & N.W. Ry.*, 260 U.S. at 44 (to be valid, "penalties . . . must be moderate and reasonably sufficient to accomplish their legitimate object"; those that are "plainly arbitrary and oppressive" violate the Due Process Clause); *St. Louis, I. Mt. & So. Ry.*, 251 U.S. at 67 (punishment is irrational and therefore violates the Due Process Clause if it is "wholly disproportioned to the offense and obviously unreasonable"); *Waters-Pierce*, 212 U.S. at 111 ("grossly excessive" civil penalties violate due process). Any other conclusion would allow juries greater sway than that accorded the legislatures that make, and

the courts that enforce, statutory civil penalties. *See Browning-Ferris*, 492 U.S. at 281 (Brennan, J., concurring) ("I should think that, if anything, our scrutiny of awards made without the benefit of a legislature's deliberation and guidance would be less indulgent than our consideration of those that fall within statutory limits.").

To protect against constitutionally impermissible arbitrariness and establish the required rational relationship to punishment and deterrence, courts adjudicating constitutional challenges to punitive awards can and should look to the various factors that have been identified by legislatures, courts, and commentators as reasonable considerations in fixing the proper amount of punitive damages. These include the character of the wrong, the motive for the defendant's conduct, including profitability to the defendant, the degree of calculation involved in the conduct, the necessity of preventing similar wrongs, the potential and actual harm caused by the defendant's conduct, the costs of litigation, the imposition of criminal penalties, the existence of other awards against the defendant arising out of the same alleged tort, and the relationship between compensatory and punitive damages. *See Pacific Mutual*, 111 S. Ct. at 1045; *Boise Dodge, Inc. v. Clark*, 453 P.2d 551 (Idaho 1969).[4]

[4] The States are, of course, free to establish different standards for use by juries in fixing the amount of punitive damages. The substantive restriction embodied in the Due Process Clause establishes an outside limit on the amount of punitive damages that may be awarded pursuant to that state law standard. *See Pacific Mutual*, 111 S. Ct. at 1043, 1046. Whether a particular award exceeds that outside limit is, of course, a question of constitutional law that must be determined by reference to a federal standard.

Importantly, *no single factor can by itself protect against arbitrariness or establish the required rational relationship in every case.* The fact situations that give rise to awards of punitive damages are simply too diverse for such an approach—different factors assume greater or lesser importance depending on the situation. The determination whether an award is constitutionally permissible must instead include consideration of all factors present in a given case that are relevant in determining whether the award is reasonably related to the purposes of punitive damages. In particular, as we next discuss, the due process standard cannot turn solely on the numerical relationship between compensatory and punitive damages. Such an approach would foster, not eliminate, arbitrariness in punitive damages awards.

B. Determining The Reasonableness Of A Punitive Award By Looking Only To The Numerical Ratio Between Compensaotry Damages And Punitive Damages Would Allow Arbitrary And Irrational Awards To Escape Condemnation Under The Due Process Clause

It sometimes has been suggested that punitive damages awards should be set at some multiple of compensatory awards. *See, e.g., Miley v. Oppenheimer & Co.*, 637 F.2d 318, 331 (5th Cir. Unit A Feb. 1981) (three times compensatory damages is "fairly good standard" for punitive damages in business torts). It may well be that a state court is free to determine that a multiple has some role to play in the assessment of punitive damages. For example, a multiple might be useful as an outside limit beyond which punitive damages would be deemed presumptively excessive and unconstitutional. However, a mechanical rule that tests the excessiveness of punitive damages *solely* by reference to their numerical relationship to

the compensatory award will produce arbitrary results in most cases. Indeed, it would be sheer fortuity if punitive damages awards that were determined only by reference to some multiple of compensatory damages resulted in rational awards. This is so because the amount of damages incurred by a plaintiff has no necessary connection to the gravity of the wrongful conduct of the defendant, the extent of the benefit obtained by the defendant as a result of the wrong, or the need for punishment and deterrence. *See In re Paris Air Crash*, 622 F.2d 1315, 1322 (9th Cir.), *cert. denied*, 449 U.S. 976 (1980) (noting that focus of punitive damages is on the conduct of the defendant rather than the harm to the plaintiff). Thus, even where a punitive damages award fell within a presumptively constitutional range, other factors must be considered and might dictate the unconstitutionality of an award.

Many courts have recognized the inherent arbitrariness of applying a simple mathematical formula to determine punitive damages. As one court has observed:

> The amount of actual damages sustained by a plaintiff is one indication of the culpability of the defendant's acts, but it cannot be the sole criterion for the assessment of punitive damages . . . . [*T*]*he application of any fixed arithmetic ratio to all cases in which punitive damages are assessed would be arbitrary.*

Boise Dodge, 453 P.2d at 557 (emphasis added). *See also Southern Life & Health Ins. Co. v. Turner*, 586 So. 2d 854, 858 (Ala. 1991) (imposing an arbitrary mathematical relationship between compensatory and punitive damages "would inevitably result in injustice"); *cf. Krause v. Merickel*, 344 N.W.2d

398, 403 (Minn. 1984) ("No hard and fast mathematical ratio can be applicable in all cases without risking gross injustice.").

The simplistic mathematical calculation of damages has been condemned in other contexts as well. For example, quotient verdicts—damages determined by adding each juror's damages figure and dividing the total by the number of jurors—are universally disfavored. *See, e.g., Watson v. Navistar Int'l Transp. Corp.*, 827 P.2d 656 (Idaho 1992); *McNamee v. Woodbury Congregation of Jehovah's Witnesses*, 475 A.2d 262 (Conn. 1984); *Johnson v. Haupt*, 623 P.2d 537 (Kan. App. 1981); *Lazarte v. City of Mountain Brook*, 248 So. 2d 148 (Ala. Crim. App. 1970), *aff'd*, 248 So. 2d 153 (Ala. 1971). The primary reason quotient verdicts are so roundly condemned is that a verdict is supposed to be the result of reason and deliberation. *See Watson*, 827 P.2d at 666.

Here too, the application of a simplistic mathematical formula would preclude reason and deliberation. Instead, juries awarding punitive damages and courts reviewing those awards for constitutional error must balance *all* factors relevant to the punitive and deterrent purposes of punitive damages. *See Pacific Mutual*, 111 S. Ct. at 1045 (Alabama juries guided by more than a single factor).[5]

[5] Although for the reasons stated in the text, a multiple of compensatory damages cannot by itself provide the sole test of the excessiveness of a jury's award of punitive damages, the analysis in no way suggests that punitive damages derived from *statutory* multiplication of compensatory damages would necessarily be unconstitutionally excessive. *Cf.* 15 U.S.C. § 15 (treble damages for antitrust violations). This distinction derives from the fundamentally different institutional roles and capabilities of juries and legislatures,

Amici frequently are faced with cases in which the alleged damages climb well into the millions and sometimes hundreds of millions of dollars. And, as compensatory damages escalate, so too does the risk of gross injustice arising from the application of a multiplier to determine punitive damages. As recognized in *Crookston v. Fire Insurance Exchange*, 817 P.2d 789 (Utah 1991), a ratio that might seem reasonable when compensatory damages are below $100,000 results in excessive punitive damages when compensatory damages are above $100,000. *Id.* at 810. Likewise, a ratio that seems reasonable when compensatory damages are below $1 million becomes patently unreasonable when compensatory damages climb into the tens of millions of dollars. Thus, the

and the much greater deference therefore due to legislative determinations. *See Browning-Ferris*, 492 U.S. at 281 (Brennan, J., concurring) ("I should think that, if anything, our scrutiny of awards made without the benefit of a legislature's deliberation and guidance would be less indulgent than our consideration of those that fall within statutory limits."). For example, a jury does not have the ability of a legislature to make detailed factual investigations to determine a rational way to fix punitive damages on the average for a particular class of cases. In contrast, legislative findings on such a question are squarely within the class of legislative determinations to which courts routinely defer. Second, unlike a legislature, a civil jury is an ad hoc body that exists only for the purpose of deciding a particular private dispute. Unlike a legislature, therefore, a jury is incapable of effectively considering the policies underlying the discrete task it is asked to perform, or the effects of its performance of that task beyond the case before it. Third, unlike a legislature, a jury does not embody the deliberate sense of the community as a whole concerning the overall purposes of punishment and deterrence, and is not directly responsible to the public at large for what it does.

use of nothing more than a predetermined ratio to evaluate punitive damages is inherently arbitrary and would not implement the requirement of rationality embodied in the Due Process Clause.

C. The Activities Of Large Accounting Firms Graphically Illustrate The Irrationality Of Determining Punitive Damages Based Solely On A Multiple Of Compensatory Damages

The situations in which amici are exposed to tort liability provide a graphic illustration of the constitutional infirmity in any rule that looks solely to a numerical ratio between compensatory damages and punitive damages.

Litigation against accounting firms most often arises out of an audit engagement. Simply stated, audits are conducted for the purpose of issuing an opinion whether, in the auditor's professional judgment, a corporation's financial position and results of operations have been fairly presented, in accordance with Generally Accepted Accounting Principles, in the financial statements issued by management. A major corporation engages in literally millions of financial transactions each year, and it obviously would be prohibitively expensive for the client to have the outside auditor review even a substantial portion of those transactions. *See Bily v. Arthur Young & Co.*, 834 P.2d 745, 749 (Cal. 1992), *modified on other grounds*, 3 Cal. 4th 1049a (Nov. 12, 1992).[6]

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[6] An audit is not intended to determine whether each individual account is correct. Rather, it is intended to provide a basis for expressing an opinion as to whether the financial statements *taken as a whole* are fairly presented in all material respects in accordance with Generally Accepted Accounting Principles. *See Codification of Auditing Standards*, Statement on Auditing Standards No. 1, § 150.02 (Am. Inst. of Certified Pub. Accountants 1991).

Regardless of the extent of the auditor's activities, the client and its management bear primary responsibility for the accuracy and adequacy of the client's financial statements. As the California Supreme Court observed in *Bily*:

> An auditor is a watchdog, not a bloodhound. As a matter of commercial reality, audits are performed in a client-controlled environment. The client typically prepares its own financial statements; it has direct control over and assumes primary responsibility for their contents. The client engages the auditor, pays for the audit, and communicates with audit personnel throughout the engagement. Because the auditor cannot in the time available become an expert in the client's business and record-keeping systems, the client necessarily furnishes the information base for the audit.

834 P.2d at 762 (citations omitted). *See also In re Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 721 (1939) ("The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon the management."); *Accounting Series Release* (ASR) No. 126 (1972), Fed. Sec. L. Rep. (CCH) ¶ 72,148; R. James Gormley, *The Law of Accountants and Auditors: Rights, Duties, and Liabilities* § 1.07[1], at 1-22 to 1-23 & nn.47-48 (1981); *Codification of Auditing Standards*, Statement on Auditing Standards No. 1, § 110.02 (Am. Inst. of Certified Pub. Accountants 1991).

In conducting their examination and rendering their opinion on management's financial statements

taken as a whole, auditors neither agree to detect every error, mistake, or dishonest act, nor guarantee that their decisions are correct. *See, e.g., SEC v. Arthur Young & Co.*, 590 F.2d 785, 788 (9th Cir. 1979) (quoting *SEC v. Republic Nat'l Life Ins. Co.*, 378 F. Supp. 430, 440 (S.D.N.Y. 1974)) (an auditor " 'is not a guarantor of the reports he prepares and is only duty bound to act honestly, in good faith and with reasonable care in the discharge of his professional obligations' "). "Moreover, an audit report is not a simple statement of verifiable fact that, like the weight of [a] load of beans can easily be checked against uniform standards of indisputable accuracy." *Bily*, 834 P.2d at 763 (citation omitted). Instead, an audit report is the subject of professional judgment. As the *Bily* court observed:

> [A]n audit report is a professional opinion based on numerous and complex factors . . . . [T]he report is based on the auditor's interpretation and application of hundreds of professional standards, many of which are broadly phrased and readily subject to different constructions. Although ultimately expressed in shorthand form, the report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage. Using different initial assumptions and approaches, different sampling techniques, and the wisdom of 20-20 hindsight, few CPA audits would be immune from criticism.

834 P.2d at 763.

Despite the limitations of the auditor's role, auditing firms often become the primary target of litigation because the client and its management often are essentially judgment-proof. Very large investments

and business transactions such as mergers and acquisitions often include consideration of the financial statements amici are called on by clients to examine. When these transactions go "sour," amici frequently "assume[] center stage as the remaining solvent defendant[s]." *Bily*, 834 P.2d at 763. Thus, amici find themselves subject to potentially very large compensatory awards even though any culpability on their part is almost always many orders of magnitude less than others involved in a particular transaction. The sheer size of the underlying investment or transaction undertaken by the client typically means that the amount of compensatory damages assessed against amici for economic loss may be in the millions of dollars and sometimes in the hundreds of millions.[7] In addition, compensatory awards are sometimes inflated by the natural tendency of juries

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[7] *See, e.g., Standard Chartered Plc. v. Price Waterhouse*, No. CV 88-34414 (Ariz. Super. Ct.) ($338 million in compensatory damages) (new trial ordered, Dec. 11, 1992); *United States Nat'l Bank of Galveston v. Coopers & Lybrand*, 89-CV-1081-A-212 (Tex. Feb. 4, 1992) ($20 million in compensatory damages, $200 million in punitive damages) (settled and vacated, Feb. 20, 1992); *SnyderGeneral Corp. v. KPMG Peat Marwick*, Civ. No. 90-14145-K (192d Judicial Dist., Dallas Cty. Tex. 1992) (settled 1992) ($10 million in compensatory damages and $2 million in punitive damages); *Hayes v. Haushalter*, MDL-00763 (D. Haw. Dec. 31, 1990), *appeal pending*, Nos. 91-15531, 91-15546, 91-15593 (9th Cir.) ($8.9 million in compensatory damages and $10 million in punitive damages awarded against Arthur Young & Company, predecessor to amicus Ernst & Young); *Westmont Tractor Co. v. Touche Ross & Co.*, No. 87-4242 (9th Cir. 1988) ($5 million in compensatory damages awarded against Touche Ross, predecessor to amicus Deloitte & Touche); *Manufacturers Hanover Trust Co. v. Arthur Andersen & Co.*, No. 82-CIV-6622 (S.D.N.Y. 1988) ($17 million in compensatory damages).

to overcompensate a plaintiff where an institutional defendant, viewed as having virtually unlimited resources, has been found responsible for even part of an innocent plaintiff's loss. *See, e.g.*, Edith Greene, *On Juries and Damage Awards: The Process of Decisionmaking*, 52 Law & Contemp. Probs. 225, 233 (Autumn 1989) (noting jury study demonstrating that jurors award plaintiffs more when the defendant is a corporation).

Such large compensatory damages are altogether disproportionate to the gravity of the alleged wrong of the accountant—a wrong that may be nothing more than professional misjudgment later found by a jury to have been "intentional," "reckless," or "grossly" negligent.[8] A multi-million-dollar compensatory award for such a misjudgment therefore already levies a very substantial punishment and deterrence on the accounting firm. *See Smith v. Wade*, 461 U.S. at 50 (exposure to compensatory liability deters potential tortfeasors).

Likewise, these very large compensatory damages are out of all proportion to the benefit an accounting firm might gain as a result of the wrong committed. Amici do not partake of the enormous economic gains shared by their clients and their clients' investment advisors; at most, the benefit that amici could expect to gain from any misconduct would be limited to the relatively modest income they receive from the particular professional services at issue. *See DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990) (two years' audit fees do not approach potential losses to audit firm from perception of participation in fraud; allegation regarding payment of fees insufficient to allege scienter). Nevertheless, because they are often the only available "deep pocket," amici are faced with claims that greatly exceed the fees received for their professional services. *See, e.g.*, Edward Brodsky, *Liabilities of Accountants*, N.Y.L.J., Dec. 9, 1992, at 3 (noting jury verdict against accounting firm that was 2400 times the firm's annual audit fee of approximately $140,000). Thus, in the vast majority of cases confronting amici, the compensatory damages awards are already disproportionate to both culpability and gain. To multiply such an award by a fixed ratio simply exacerbates the disproportionality by building upon an already shaky foundation.

Accordingly, it is apparent that, in the context of litigation against auditors, the punitive and deterrent purposes of punitive damages already are served quite well by compensatory damages. *See Carey v. Piphus*, 435 U.S. 247, 256 (1978) (compensatory damages "formidable" deterrent); *Smith v. Wade*, 461 U.S. at 94 (O'Connor, J., dissenting) ("awards of compensatory damages and attorney's fees already provide significant deterrence").[9] In these circum-

[8] The type of conduct required to obtain an award of punitive damages varies greatly among the states. Not all states require malicious or egregious conduct; several allow punitive damages simply upon a finding of "gross negligence." *See, e.g., Wooderson v. Ortho Pharmaceutical Corp.*, 681 P.2d 1038 (Kan.), *cert. denied*, 469 U.S. 965 (1984); *Art Hill Ford, Inc. v. Callender*, 423 N.E.2d 601 (Ind. 1981).

[9] The purposes of punishment and deterrence are further served by professional discipline. Auditors are subject to disciplinary action by both the American Institute of Certified Public Accountants and state boards of accountancy. Discipline can be severe; an accountant's license may be suspended or revoked for dishonesty, fraud, or gross negligence in the practice of accounting. *See, e.g.*, Pa. Stat. Ann. tit. 63,

stances, the rote application of a prescribed multiple of compensatory damages probably would never produce a constitutionally permissible measurement of punitive damages awards. For example, in *Manufacturers Hanover Trust Co. v. Arthur Andersen & Co.*, No. 82-CIV-6622 (S.D.N.Y. 1988), the jury awarded compensatory damages of $17 million. Following the standard suggested by the Fifth Circuit in *Miley*, 637 F.2d at 331—three times compensatory damages—a punitive damages award of $51 million would be deemed appropriate. Applying the test espoused by the court below—five times compensatory damages for "really stupid" conduct—the permissible punitive damages award would rise to $85 million. An even more graphic illustration of the absurd results of the rote application of a multiplier is provided by the compensatory damages award in *Standard Chartered Plc. v. Price Waterhouse*, No. CV 88-34414 (Ariz. Super. Ct.) (new trial ordered, December 11, 1992). In that case, the jury awarded compensatory damages of $338,000,000, despite the fact that the annual audit fee was approximately $140,000. Thus, the compensatory damages themselves were completely out of proportion to any "gain" obtained by Price Waterhouse. And applying a standard of three times compensatory damages would result in a punitive damages award of over $1 *billion*. Using a multiplier of five, the permissible punitive damages award would rise to nearly $1.7

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§ 9.9a; Tex. Rev. Civ. Stat. Ann. art. 41a-1, § 21; W. Va. Code § 30-9-12. In addition, the rules of the Securities and Exchange Commission provide that it may bar an accountant from practicing before it if it finds that the accountant has engaged in "unethical or improper professional conduct." *See* 17 C.F.R. § 201.2(e)(ii).

billion. It is self-evident that such awards cannot pass constitutional muster. Such arbitrary awards are the inevitable result of the simplistic application of a multiplier to determine punitive damages. Accordingly, the Court should reject any standard for awarding or evaluating punitive damages that looks solely to such a multiplier.

CONCLUSION

The judgment of the Supreme Court of West Virginia should be reversed.

Respectfully submitted.

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